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DEPARTMENT PASS TREASURY, FEDERAL RESERVE BOARD, LABOR

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SUBJECT: INCOMES POLICY -- THE WAY AHEAD

SUMMARY: AFTER 2 YEARS OF VISIBLE COLLABORATION AMONG
ORGANIZED LABOR, THE BUSINESS COMMUNITY AND THE GOVERN-
MENT, THE PROCESS OF PAY DETERMINATION HAS RECENTLY EVOL-
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VED INTO ONE OF GOVERNMENT LEADERSHIP MATCHED BY ACQUI-
ESCENCE ON THE PART OF THE TUC. THIS POSTURE HAS BEEN A
SOURCE OF STRENGTH TO THE GOVERNMENT DURING THE CURRENT
PAY ROUND. WHILE THE OUTCOME OF THAT ROUND REMAINS FAR
FROM SETTLED, THERE IS GROWING CONFIDENCE AMONG POLI-
TICIANS AND SENIOR CIVIL SERVANTS THAT A RISE IN AVERAGE
EARNINGS OF LESS THAN 15 PERCENT IS ATTAINABLE, A VIEW CON-

CURRED IN BY THE CBI. DESPITE THE GOVERNMENT'S 10 PERCENT GUIDELINE, SUCH AN OUTCOME WOULD BE GRATEFULLY WELCOMED BY HMG. INDEED, VARIOUS MINISTERS INCLUDING THE PRIME MINISTER AND THE CHANCELLOR OF THE EXCHEQUER HAVE ALREADY BEGUN TO LOOK BEYOND MID-1978. IN RECENT WEEKS, A SERIES OF TRIAL BALLOONS HAVE BEEN FLOATED CALLING FOR A MORE PERMANENT MECHANISM FOR INCOMES POLICY DETERMINATION AS WELL AS A LOWER WAGE NORM (POSSIBLY 5 PERCENT) FOR THE NEXT PAY ROUND. THIS MESSAGE EXAMINES THE ECONOMIC IMPLICATIONS OF INCOMES POLICIES AND TRIES TO EXPLAIN HMG'S APPARENT ATTRACTION TO THE IDEA OF SUPPLANTING THE FUNCTIONS OF THE LABOR MARKET AND EXPERIMENTING WITH A PERMANENT INCOMES POLICY MECHANISM. END SUMMARY.

1. BACKGROUND. DURING MUCH OF THE THREE DECADES SINCE 1948, BRITAIN HAS HAD SOME FORM OF INCOMES POLICY. WITH THE EXCEPTION OF A 2-YEAR GAP IN THE EARLY 1970S, INCOMES POLICIES HAVE BEEN A REGULAR FEATURE OF THE ECONOMIC LANDSCAPE SINCE JULY 1961. THEIR NATURE HAS RANGED FROM STATUTORY TO VOLUNTARY. THEY HAVE BEEN SUPPORTED, OPPOSED OR ACQUIESCED IN BY ORGANIZED LABOR. IN GENERAL, THEY HAVE FAILED TO ACHIEVE THEIR STATED AIMS.

2. IMMEDIATELY AFTER THE WAR (1947-50), INCOMES POLICY WAS ROOTED IN CONDITIONS OF INDUSTRIAL DISARRAY, LABOR SHORTAGES, AND AN ADVERSE BALANCE OF PAYMENTS. DURING LIMITED OFFICIAL USE

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THE 1950S THE VAST DEMANDS OF RECONSTRUCTION COUPLED WITH THE CONTINUING EXISTENCE OF MANY OF BRITAIN'S PROTECTED MARKETS IN THE EMPIRE MADE IT POSSIBLE TO MAINTAIN FULL EMPLOYMENT, PRICE STABILITY, AND A REASONABLE BALANCE OF PAYMENTS POSITION. THE END OF POST-WAR RECONSTRUCTION COINCIDED WITH THE DILUTION OF BRITAIN'S PROTECTED OVERSEAS MARKETS AND LEFT BRITISH INDUSTRY INCREASINGLY EXPOSED TO FOREIGN COMPETITION BOTH AT HOME AND ABROAD. INCOMES POLICY WAS REVIVED IN 1961 IN AN ATMOSPHERE OF TIGHT LABOR MARKETS, TRADE UNION POWER IN KEY SECTORS OF THE LABOR MARKET AND A MACROECONOMIC POLICY CONSTRAINED BY A DETERIORATING BALANCE OF PAYMENTS. AS A POLICY INSTRUMENT, INCOMES POLICY WAS AIMED AT RECONCILING FULL EMPLOYMENT WITH PRICE STABILITY. WITH LABOR MARKETS GENERALLY TIGHT, THE IDEA WAS TO HOLD WAGE INCREASES TO THE ANNUAL RISE IN PRODUCTIVITY THEREBY KEEPING BRITISH EXPORTS AND IMPORT SUBSTITUTES COMPETITIVE AND PRODUCING RELATIVE PRICE STABILITY. STRONG UNIONS WERE EXPECTED TO AGREE TO STATUTORY LIMITATIONS ON THEIR WAGE DEMANDS IN RETURN FOR PUBLIC EXPENDITURE AND TAX POLICIES FAVORABLE TO THEM. THIS WAS THE APPROACH OF THE LABOR GOVERNMENT AFTER ITS RETURN TO POWER IN 1964. THE TORIES, AFTER

THEIR RETURN IN 1970, PLACED LESS EMPHASIS ON ANY QUID
PRO QUO'S FOR UNION COOPERATION.

3. AS BOTH THE LABOR GOVERNMENT AND ITS TORY SUCCESSOR
WERE TO DISCOVER, INCOMES POLICIES TEND TO FOLLOW A CY-
CLICAL PATTERN. THE INTENT IS INITIALLY TO PRODUCE A

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A CHANGE IN BOTH PRICE AND WAGE EXPECTATIONS. THIS HAS
AN IMMEDIATE IMPACT ON THE PROBABLE SHAPE OF INDUSTRIAL
COSTS. AFTER A YEAR OR SO, THE WAGE NORMS AT THE HEART
OF THE POLICY (IT MUST BE SIMPLE IF IT IS TO BE WORKABLE)
BEGINS TO PRODUCE A PATTERN OF LABOR MARKET ANOMALIES
BOTH BETWEEN AND WITHIN SECTORS. FINALLY, THE CYCLE IS
COMPLETED AS AFFECTED GROUPS OF WORKERS OR UNIONS IN-
CREASE THE PRESSURE TO EASE THE ACCUMULATED STRAINS AND

TO RESTORE THE STATUS QUO ANTE. THIS LEADS TO A SITUATION WHERE, BECAUSE OF THEIR MARKET POWER, THE MORE POWERFUL UNIONS DEMAND AND WIN PAY INCREASES WHICH OFFSET LIMITED OFFICIAL USE

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MOST IF NOT ALL OF THE GAINS IN REDUCING WAGE INFLATION MADE DURING THE PREVIOUS PERIOD OF RESTRAINT. THIS PATTERN REPEATED ITSELF TWICE DURING THE 1960S AND EARLY 1970S.

4. THE MOST RECENT EXPERIENCE (1975-1978) WITH INCOMES POLICY FOLLOWED AN 8-YEAR SPAN UNDER BOTH LABOR AND TORY RULE WHEN PAY DETERMINATION WAS GOVERNED BY STATUTE. THE FINAL YEAR OR SO (1973-74) OF THAT PERIOD WAS CHARACTERIZED BY INCREASING CONFRONTATION BETWEEN THE MINERS, WITH TUC SUPPORT, AND THE HEATH GOVERNMENT WHICH CULMINATED IN THE RETURN OF A LABOR GOVERNMENT IN FEBRUARY 1974.

5. THE CURRENT SITUATION. THE ECONOMY IS NOW PASSING THROUGH A PERIOD CORRESPONDING TO THE LATE SECOND AND EARLY THIRD STAGES OF THE INCOMES POLICY CYCLE WHEN CONSIDERABLE DISSATISFACTION AMONG CERTAIN GROUPS (FIREMEN, ENGINEERING AND POWER WORKERS, ETC.) IS BECOMING MORE EVIDENT. STAGES I AND II (MID-1975 TO MID-1977), DESIGNED TO ALLOW AVERAGE EARNINGS INCREASES OF ROUGHLY 11 PERCENT AND 5 PERCENT, RESPECTIVELY, CAME WITHIN THREE PERCENTAGE POINTS OF ACHIEVING THEIR TARGETS. IT IS THE EXISTENCE OF THIS KIND OF SLIPPAGE, IN THE FACE OF GENERAL SUPPORT FOR WAGE RESTRAINT FROM BOTH SIDES OF INDUSTRY, THAT WORRIES THE PRIME MINISTER AND THE CHANCELLOR, BOTH REGARDING THE CURRENT PAY ROUND AND THE ONE STARTING NEXT AUGUST. THEIR CURRENT TACTICS REFLECT A DESIRE TO POSTPONE THE TERMINAL PHASE OF THE CYCLE. THIS IS THE RATIONALE FOR THE RECENT MINISTERIAL CRESCENDO IN SUPPORT OF FURTHER WAGE RESTRAINT INTO 1979, A LOWER WAGE NORM, AND SOME FORM OF PERMANENT MECHANISM TO DEAL WITH THE ANOMALIES INHERENT IN INCOMES POLICIES. (SEVERAL HMG SOURCES VIGOROUSLY DENY ANY COORDINATED STRATEGY BEHIND LIMITED OFFICIAL USE

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RECENT MINISTERIAL STATEMENTS. YET THEY DO NOT DENY THAT SOME MECHANISM TO RESTRAIN EARNINGS WILL BE NEEDED TO KEEP WEAKER SEGMENTS OF THE LABOR FORCE FROM BEING LEFT BEHIND IN NEXT YEAR'S WAGE BARGAINING.)

6. SINCE 1975 WHEN THE PRESENT POLICY CYCLE BEGAN WAGES,

RETAIL PRICES AND UNEMPLOYMENT HAVE FOLLOWED A CLEAR PATTERN. THIS IS SET OUT IN THE FOLLOWING TABLE IN WHICH PRICE AND WAGE CHANGES ARE GIVEN QUARTERLY AND EXPRESSED AT ANNUAL RATES. THE UNEMPLOYMENT (S.A.) DATA REPRESENT THE MONTHLY AVERAGE FOR THE QUARTER.

		PERCENT CHANGE			UNEMPLOYMENT	
		BASIC(1) HOURLY	WAGE	RETAIL PRICE	DAYS LOST	MENT
		AVERAGE	RATES	INDEX	STRIKES(2)(S.A.)	RATE
		EARNINGS				
1975	II	20.0	31.0	37.6	2.47	3.6
	III	25.3	20.5	17.5	1.40	4.2
	IV	15.0	18.1	13.8	0.71	4.8
1976	I	13.3	24.1	14.6	0.87	5.2
	II	12.3	14.3	14.5	0.72	5.3
	III	10.7	11.9	9.3	0.93	5.5
	IV	10.9	2.8	18.5	0.77	5.5
1977	I	11.0	7.3	20.1	1.25	5.6
	II	7.1	4.5	17.8	1.82	5.6
	III	4.5	4.3	6.3	2.40	6.0
	EST. IV	11.5	2.5	5.9	3.43	6.1

(1) - BOTH EARNINGS AND WAGES ARE GIVEN SINCE THE WAGE FIGURES ARE DISTORTED BY THE EXCLUSION OF A LARGE SEGMENT OF THE MANUAL LABOR FORCE FROM THE INDEX BEGINNING EARLY IN 1977.

(2) - MILLIONS OF DAYS.

7. SUPERFICIALLY, THESE FIGURES PERMIT ONE TO MAKE A CASE FOR THE INITIAL EFFECTIVENESS (I.E., PHASES I AND II 1975-III - 1977-III) OF THE CURRENT INCOMES POLICY. THEY ALSO SUPPORT THE CONCLUSION THAT THE CYCLE HAS ENTERED LIMITED OFFICIAL USE

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ITS TERMINAL PHASE. THE QUARTERLY INCREASE IN EARNINGS/ WAGES WAS HALVED DURING THE FIRST FOUR QUARTERS AND HALVED AGAIN DURING THE NEXT FOUR. THE SAME PATTERN IS PRESENT FOR RETAIL PRICES ALTHOUGH IT IS INTERRUPTED BE-

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TWEEN 1976-IV AND 1977-II AS THE IMPACT OF STERLING'S
SLIDE INFLUENCED THE INDEX. DAYS LOST TO WORK STOPPAGES
DROP SHARPLY THROUGH 1975 REMAINING LOW IN 1976, BUT BE-
GIN TO RISE RAPIDLY IN 1977 REFLECTING BOTH INCREASING
FRICTION OVER PAY ANOMALIES AND ERODED REAL INCOMES.

8. THESE FIGURES MUST ALSO BE JUDGED AGAINST AN ECONOM-
IC BACKGROUND OF STAGNANT OUTPUT, RISING UNEMPLOYMENT AND
RESTRICTIVE FISCAL AND MONETARY POLICY, ALL OF WHICH HAVE
AN IMPACT BOTH ON THE DEMAND FOR LABOR AND HENCE ITS
PRICE (WAGE) AND ON AGGREGATE DEMAND AND HENCE RETAIL
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PRICE MOVEMENTS. AS A RESULT IT CAN BE ARGUED THAT THE
SLOWING IN THE RATE OF WAGEINCREASE OWES MORE TO SLACK
LABOR MARKET CONDITIONS AND RESTRICTIVE MONETARY POLICY
THAN TO INCOMES POLICY PER SE.

9. WHILE THE DEBATE OVER THE ECONOMIC EFFECTIVENESS OF
THE PRESENT INCOMES POLICY CONTINUES, THE GOVERNMENT MUST
ALSO DEAL WITH SEVERAL VERY REAL CONSIDERATIONS IN SHAP-
ING ECONOMIC POLICY DURING THE COMING YEAR. MOST IMMEDI-
ATELY, THERE IS LEEWAY WITH BRITAIN'S IMF COMMITMENTS FOR
A SUBSTANTIAL FISCAL STIMULUS IN THE SPRING BUDGET. NEXT,

AS ECONOMIC ACTIVITY RESPONDS TO THAT STIMULUS, PRESSURES MAY APPEAR IN THE LABOR MARKET, PARTICULARLY AMONG THE HIGHLY SKILLED GROUPS. THIRD, THESE PRESSURES WILL COINCIDE WITH THE END OF THE CURRENT PAY ROUND NEXT SUMMER WHEN AN ELECTION WILL BE LOOMING INCREASINGLY LARGER ON THE HORIZON. FINALLY, THERE IS HMG'S CONCERN OVER THE INEQUITIES TO THE LESS WELL ORGANIZED ELEMENTS IN THE LABORFORCE RESULTING FROM A RETURN TO FREER COLLECTIVE BARGAINING. THUS, THE OUTLOOK FOR A FURTHER PERIOD OF INCOMES POLICY IS CLOUDED BY POLITICAL QUESTIONS OF EQUITY AND TIMING, THE IMPACT OF A MORE BUOYANT ECONOMY, AS WELL AS BY THE VERY OBVIOUS FACT THAT A FOURTH PHASE WILL MEAN ANOTHER YEAR DURING WHICH WAGE INCREASES COULD BE PERCEIVED TO BE AS MUCH PERMITTED BY GOVERNMENT AS WON BY TRADE UNION BARGAINING. WHILE SOME KEY TUC LEADERS RECOGNIZE THE LIMITATIONS OF FREE COLLECTIVE BARGAINING IN CURRENT ECONOMIC CIRCUMSTANCES, AND ARE CURRENTLY ACQUIESCING TO GOVERNMENT IN ESTABLISHING OVERALL WAGE NORMS, THEY ARE JEALOUS ABOUT PRESERVING COLLECTIVE BARGAINING AS A GENERAL PRINCIPLE OF FREE TRADE UNIONISM. THIS OPENS THE QUESTION OF TRADE UNION RESPONSES TO GOVERNMENT SUGGESTIONS FOR A FURTHER PERIOD OF INCOMES LIMITED OFFICIAL USE

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POLICY. IN PUBLIC SECTOR, THE PICTURE IS SOMEWHAT DIFFERENT SINCE THE GOVERNMENT IS THE EMPLOYER. INDEED, THERE HAS BEEN SATISFACTION IN HMG, PUBLICLY EXPRESSED BY MR. HEALEY, AT GENERAL AND MUNICIPAL WORKERS' CHIEF DAVID BASNETT'S PROPOSAL FOR A PUBLIC SECTOR PAY NORM, WHICH IS THE PRODUCT OF BARGAINING BETWEEN THE GOVERNMENT AND PUBLIC SECTOR UNIONS. AS YET, THE BASNETT PROPOSAL HAS NOT WON BROAD UNION SUPPORT.

10. WITH THE TORIES VIGOROUSLY ASSUMING THE ROLE OF CHAMPIONS OF A RETURN TO FREE COLLECTIVE BARGAINING IN THE PRIVATE SECTOR, IT IS LIKELY THAT CALLAGHAN WILL BE FORCED TO USE ALL OF HIS PERSUASIVE ABILITY AND POLITICAL SKILL TO ENSURE THAT SOME FORM OF INCOMES POLICY SURVIVES BEYOND JULY 1978.

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